

4. If the Commission Retains the Service Quality Component In the PCI, the Penalty Percentage Must Be Significantly Increased To Match The Level That Would Occur If Applied Outside the Plan.

As noted above, both GCI and Staff concur that the service quality component of any alternative regulatory plan should be removed from the price cap index. However, should the Commission conclude that the service quality adjustment should remain within the price cap index, the Commission must insure that the adjustment provides sufficient incentive to improve and maintain service quality, similar to the proposed out-of-plan penalty provision proposed by GCI.

In order for the service quality adjustment to the Price Cap Index (PCI) to be effective, it must be substantially more than the current .25% adjustment. By increasing the adjustment to 1.25%, the Commission would require the Company to reduce rates by \$13 million per violation, which is slightly more than has been proposed for the adjustment outside the PCI. GCI Ex. 2.0 at 76. Similar escalations for severity of the service quality degradation, repeated and multiple violations to those proposed for adjustments outside the PCI should also be added to the formula. The formulas for these escalations, along with examples of calculations, can be found in GCI Ex. 2.0, pages 77 – 78.

In addition, the Commission should reject the Company's request to adjust the PCI back upward if the Company subsequently achieves a benchmark it already missed. The Commission determined in the last price cap Order that no such provision was appropriate if service quality, at a minimum, was to be maintained. The Company's decline in service quality performance during the life of the plan does not justify such a change. Indeed, given the Company's strict adherence to "economically rational" behavior when it comes to service quality, the promise that a revenue reduction might be undone in a coming year decreases the incentive to provide service

quality at acceptable levels.

Staff's proposal for an inside-the-plan service quality component retains the 0.25 penalty percentage for all service quality measures, and increases the PCI-related reduction for the OOS>24 and POTS % Installation Within 5 Days measures to 2 percent per year, with no escalation provision. Staff Brief at 79. Staff also proposes that the PCI be adjusted to its pre-penalty level if the Company achieves a previously missed benchmark for 12 consecutive months. Id.

Staff's "within-the-index" proposal is deficient for a couple of reasons. First, contrary to Staff's assessment, increasing the OOS and installation measures to 2 percent, without any escalation for the degree of a benchmark miss, would only create a penalty of \$20.8 million rather than the \$32 million cited in Ms. Jackson's testimony, due to the reduction of noncompetitive service revenues resulting from IBT's reclassification of services. Staff Ex. 9.0 at 42. As discussed earlier, even the threat of a \$30 million penalty as a result of the Merger Order for noncompliance with the OOS>24 benchmark was not enough to incite the Company to fix its service quality failings. Thus, \$20.8 million is unlikely to trigger any change in IBT's behavior.

Second, use of disparate penalty percentage levels may give IBT the incentive to prioritize its service quality performance. Ms. TerKeurst's proposed escalating mechanism, in contrast, would help ensure that the Company viewed each measure as important. Finally, the Staff proposal to re-adjust the PCI, similar to IBT's proposal, effectively negates the incentives provided by the penalty mechanism, and should be rejected.

GCI urge the Commission to adopt the service quality incentive proposals proposed by Ms. TerKeurst, as discussed in detail in CUB's and the AG's Initial Briefs, in order to ensure that

service quality under the new plan is, at a minimum, maintained, as required under Section 13-506.1(b)(6) of the Act.

V. REVENUE REQUIREMENTS ANALYSIS

The Company's assertion that reinitializing rates in accordance with GCI's and Staff's proposed adjustments would "effectively bankrupt Ameritech Illinois" is unsupported rhetoric that should be dismissed out of hand. Reinitializing rates is both required under the Act and contemplated in the Commission's 1994 Alt. Reg. Order at 50, 51, 92-94, 186. Both Staff accounting witnesses and GCI witness Ralph C. Smith examined the Company's 1999 jurisdictional rate base and operating income statement and concluded that the Company is significantly overearning. Mr. Smith concluded that the Company is earning a 43.08% return on equity for intrastate operations and a 28.49% return on intrastate rate base. GCI/City Ex. 6.2 at 3. His review of the Company's intrastate revenue requirement shows an Illinois intrastate revenue excess of \$956 million, as shown on GCI Ex. 6.5, Schedule A Revised, demonstrating the need to reinitialize rates prior to the establishment of a going-forward regulatory plan. Staff's accountants concurred that a significant rate reduction is in order, having computed a revenue excess of \$824 million for the 1999 test year. Staff Ex. 30.0 at 4.

As noted in CUB's Initial Brief (p.108), the Company's own calculation of its adjusted net operating income and adjusted intrastate rate base for the 1999 test year, which does not incorporate the operating income and rate base adjustments recommended by either Mr. Smith or the Staff witnesses, but does incorporate its own pro forma adjustments that effectively lower its reported earnings, reveals an intrastate revenue excess of \$276 million. GCI Ex. 6.5, Schedule A Revised. Clearly, a significant rate reduction in the Company's going-forward rates is in order.

IBT offered arguments against the adoption of the adjustments, both to AI's intrastate operating income and reported rate base, that should be reflected in the Company's going-forward rates. A detailed response to IBT's arguments against these proposed adjustments follows.

A. Revenue and Expense Adjustments

1. Directory Revenues

In its "History of the Issue" section, the Company describes the affiliate relationship among IBT and the affiliated companies that publish Yellow Pages directories. IBT Brief at 102. In an attempt to confuse the issue and suggest that this Commission has no jurisdiction over the question of how Yellow Pages *revenues* should be treated, IBT notes, "The Commission does not regulate classified advertising or the Yellow Pages and has never regulated Donnelley (the original Yellow Pages directory publisher)." IBT Brief at 103. The Company adds that Yellow Pages are not subject to regulation because classified advertising does not fall within the definition of a "telecommunications service". Id. While the Company is correct in asserting that the Commission does not regulate classified advertising, Yellow Pages or Donnelley, these points are irrelevant to the fact that the Commission *does* have authority over affiliate transactions pursuant to Section 7-102 and 7-203 of the Act, among other provisions. More specifically, the Commission has authority to determine whether revenues are being improperly diverted to an unregulated affiliate to the detriment of the regulated telephone company. This is precisely the issue at hand in this docket.

The Company next attempts to distort the testimony of Staff witness Everson and GCI/City witness Smith in order to obfuscate the issue. For example, the Company writes that "GCI witness Smith's principal rationale for imputation appeared to be his belief that the

Commission regulates the Yellow Pages and has discretion to allocate to Ameritech Illinois whatever portion of API's advertising revenues it deems appropriate." IBT Brief at 110. In fact, Mr. Smith never made such an assertion. See gen'ly GCI/City Ex. 6.0 at 20-29, GCI/City Ex. 6.5 at 31-44. The foundation for Mr. Smith's adjustment is the recognition that the Commission has the authority, and is legally obliged, to ensure that IBT affiliates are not profiting at the expense of monopoly ratepayers.

IBT next implies that Mr. Smith believes IBT at one time received advertising revenues. IBT Brief at 110. Once again, this is nothing more than an attempt to put words in Mr. Smith's mouth. The specific statement that "the Commission has always included revenues from IBT's Yellow Pages advertising in the calculation of the Company's revenue requirements" comes directly from page 101 of the 1994 Alt. Reg. Order. By referencing this language, Mr. Smith was acknowledging the imputation of revenues regularly made by the Commission in computing IBT's revenue requirements, *as stated by the Commission itself*.

As noted in CUB's Initial Brief, the basis for Mr. Smith's imputation of directory revenues is a recognition for regulatory purposes of the diversion of these revenues away from the local, regulated telephone company and into an affiliate publishing company. As noted in Mr. Smith's testimony, the Illinois Appellate Court upheld the Commission's decision, which noted that the issue of imputing directory revenues implicates sections 7-102, 7-102(c) and 7-203 of the Act. See CUB Initial Brief at 109-110, Illinois Bell Telephone Co. v. ICC, slip op. of July 17, 1996, attached as GCI/City Ex. 6.4.

In response to Mr. Smith's testimony that IBT could have chosen to publish its own Yellow Pages, but instead allowed Ameritech Corporation to divert the revenues from this lucrative enterprise into an unregulated affiliate, IBT opines that the decision that API would

publish the directories was made in a 1984 agreement that was approved by the Commission. IBT Brief at 111. IBT's adds the similarly irrelevant argument that IBT has no legal obligation to publish Yellow Pages directories, and opines that "Mr. Smith's rationale is presented 16 years too late." Id.

Once again, the Company attempts to muddle the issue. The decision to permit its affiliate, API, to publish the directories was not the basis for the Commission's 1994 imputation of directory revenues, nor is it the basis for the imputation proposal in this docket. In 1994, what was relevant was that Ameritech Illinois failed to engage in arms-length negotiations with API, a related affiliate. If it had, the Commission concluded, it could have secured more favorable terms, i.e. additional revenues, from API. In this docket, the need to impute at least \$126 million in revenues remains. The fact that API "had no desire to negotiate a comparable agreement for the future" is not a basis for assuming that Ameritech or Ameritech Illinois suddenly lost all bargaining power, given API's related affiliate status. Because API is a related affiliate, Ameritech and IBT permitted the contract to expire without renegotiation of the term that flowed through to IBT an additional \$76 million in revenues. Accordingly, neither the fact that the Commission once approved the contract between API, Donnelley, IBT and Ameritech nor the expiration of that contract changes the fact that revenues need to be imputed to the regulated monopoly, who but for the Ameritech Corporation's and IBT's decisions to (1) let API publish the directories, (2) fail to engage in arms-length negotiations to obtain better terms for the regulated monopoly, IBT, when extending the term of the contract to 1999, and (3) permit the contract to expire in December of 1999, IBT would have received, at a minimum, an additional \$126 million in revenues from API.

IBT puts forth another strawman argument by asserting that ratepayers would have no

claim on the unregulated division's advertising revenues, just as they have no claim on Donnelley's or API's advertising revenues, if IBT were to enter the publishing business. IBT Brief at 112. Again, neither Staff nor GCI is claiming that IBT is entitled to the advertising revenues API collects. Rather, the imputation recognizes, in effect, the payment of a royalty fee by the affiliated publisher of the directories – in this case, API – to the local telephone company in recognition of the fact that but for the decision of the corporate parent Ameritech to funnel the directory publishing business into an affiliate company, the regulated local telephone company would be realizing the considerable revenues associated with this lucrative business.

The Company attempts to further confuse the issue by asserting “API is paying IBT the maximum rate required by law for listing services and the standard rate paid by all customers for billing and collection services.” IBT Brief at 110. Here, the Company references the Telecommunications Act of 1996 (“TA 96”), which includes a provision (Section 222(e)) that requires IBT to provide non-affiliated directory publishers with listing information in a fair, impartial and nondiscriminatory manner, and limits IBT to charging such publishers \$0.04 per directory listing and \$0.06 per listing for updates. Once again, the revenues the TA 96 provision covers are separate and apart from the \$126 million in directory revenues at issue here, and the Company knows that. This provision of TA 96 does *not* prohibit telephone companies from publishing directories or selling advertising in such directories, and thereby does not affect a local telephone company's ability to negotiate the receipt of additional revenues in exchange for the local company's endorsement (and thus the use of its name) on that particular directory. Nor does it prohibit state regulatory commissions from using directory revenues in determining the intrastate revenue requirement for the telephone company. Entities within the Ameritech (now SBC/Ameritech) corporate group have continued to publish and distribute directories in Illinois

and to realize substantial revenues from directory operations. GCI/City Ex. 6.0 at 22-23. The \$2.2 million for listing and billing and collection service, per a "prevailing price valuation standard", was neither removed nor a part of the Company's pro forma adjustment to remove about \$76 million from the 1999 test year. Id. at 23.

The Company also contends that IBT lost its bargaining power with API "due to public policy changes implemented by Congress and the courts" consisting of: (1) the loss of the copyright in directory listings, (2) the prohibition on discrimination between directory publishers, which took away IBT's ability to provide premium listing services to a preferred publisher, and (3) the fixed, maximum rates set by the FCC for directory listings. IBT Brief at 109. This strawman argument is nothing more than a reference to TA 96, and its effect on the regulated telephone company's charges for listing and billing and collection services. As noted above and in CUB's Initial Brief, those charges are not at issue in this docket.

Moreover, the U.S. Supreme Court decision referenced by the Company at page 116 of its Brief, which eliminated telephone companies' copyright in directory listings, is inapposite. First, that decision was entered in 1991, three years before the Commission ruled an imputation of revenues was appropriate in the 1994 Alt. Reg. Order. Accordingly, it did not affect the Commission's decision in that case in any way. Second, the elimination of the copyright in directory listings is irrelevant to the issue of whether API should have compensated Illinois Bell for the exclusive right to publish directories with the Ameritech name on them.

IBT further argues in its Brief that the Commission estimated the imputation amount applied in the last rate case based upon the average revenues, calculated on a per access line basis, that IBT's sister operating companies (Wisconsin Bell, Michigan Bell, Indiana Bell and Ohio Bell) were then receiving for directory services. The Company then cites API employee

Michael Barry's testimony and opines that because those companies operate under the same limitations and agreements as IBT and "enjoy the same level of payments", there should be no imputation in the present case. IBT Brief at 109.

This argument is yet another red herring. In fact, Mr. Barry testified that "API offers and has signed substantially the same directory agreement with all of the LECs (including Ameritech Michigan, Ameritech Ohio, Ameritech Wisconsin and Ameritech Indiana) and CLECs with which it has contracted." AI Ex. 11.0 at 13. Mr. Barry then stated, "API has not sought and is not paying for any telephone company endorsement." Id. Once again, it is of course not surprising that the affiliate, API, "has not sought" any telephone company endorsement. As the affiliate of these Ameritech local exchange companies, it would not need to seek such an endorsement. If API is not paying additional dollars for the Ameritech endorsement on its directories, it is because neither the Ameritech corporation nor the individual Ameritech LECs have required it. The issue is do such contracts fairly compensate the regulated company for the inappropriate transfer of directory revenues from IBT to an affiliate, API? As this Commission and the Illinois Appellate Court have recognized, the answer is a resounding "no." Both the Commission and the Illinois Appellate Court affirmed that directory revenues should be imputed to IBT for purposes of calculating its intrastate revenue requirements. Moreover, the Company's argument fails because conspicuously absent from Mr. Barry's testimony is any discussion of whether those regulated telephone companies are required to *impute* revenues for purposes of computing a revenue requirement by the individual state commissions. Accordingly, IBT's argument in this regard is not persuasive.

The Company next argues that the Commission's rules militate against imputing revenues. IBT Brief at 109. The Company writes that Commission Rule 310.60 waives the

requirement for approval of an affiliate contract where such approval is still required in the case of :

Contracts or arrangements made in the ordinary course of business for the purchase of services, supplies, or other personal property at prices not exceeding the standard or prevailing market prices, or at prices or rates fixed pursuant to law.

83 Ill. Admin. Code Part 310.60. The Company opines that API is paying IBT the maximum rate required by law for listing and billing and collection services, and thus under this rule, those rates are per se reasonable. IBT Brief at 110. Once again, the rate IBT is being compensated for listing and billing and collection services is not at issue, and constitute amounts separate and apart from the \$76 million IBT removed as a pro forma adjustment to its 1999 test year. This rationale for rejecting a continued imputation, accordingly, should be rejected.

IBT next suggests that a decision by the Washington Utilities and Transportation Commission to make a similar imputation with respect to Pacific Northwest Bell ("PNB") is not analogous to the circumstances in Illinois, and therefore does not support imputation, because PNB "had always published the Yellow Pages". IBT Brief at 112. IBT's interpretation of this ruling is wrong. The Washington Commission ordered the continued imputation of revenues for the same reasons this Commission should: it recognized the value of the "going business" of Yellow Pages to the local telephone company and the necessity of reflecting that value for ratemaking purposes. Thus, even though PNB stopped publishing the directories in 1984, the Washington Commission required then and now the imputation of revenues associated with the business for ratemaking purposes. In this docket, the expiration of the contract with affiliate API does not change the fact that the Yellow Pages business and the exclusive right to publish directories with the Ameritech name on them is lucrative, and that but for its affiliate relationship

with Ameritech Corporation and IBT, API would not enjoy that benefit, or at the very least, would be paying a handsome fee for this exclusive right. Accordingly, the revenues API reaps as the exclusive purveyor of "Ameritech" directories must be shared (or imputed) with the regulated LECs that bear the Ameritech name.

Yet another red herring argument is IBT's assertion that the Company "presented undisputed testimony that its new agreement with API is equally as favorable to the Company as the agreements that over 70 CLECs and one ILEC have negotiated at arm's length with API." IBT Brief at 108. The Company opines that API is paying IBT the maximum rate prescribed by law for listing information and at market rates for billing and collection services. Id. IBT then argues, "Ms. Everson failed to even consider this evidence." Id. In fact, API's agreements with non-Ameritech companies are irrelevant to the issue at hand. Again, the rate paid for listing and billing and collection services is unrelated to the issue of whether the Ameritech local telephone company (IBT) was compensated by API for the value of the exclusive right to place the Ameritech name on the the API-published directories. The fact that API, Ameritech and IBT allowed the contract to expire does not change the fact that revenues need to be imputed to IBT for ratemaking purposes. While Staff witness Everson's explanation for the directory revenue imputation adjustment was not as lengthy and detailed as Mr. Smith's, her belief that the imputation of directory revenues should continue is a sound one. Ms. Everson was clearly aware that the 1984 contract expired in December of 1999. Tr. 801-802. Much to the Company's chagrin, Ms. Everson simply disagreed with the Company that API's decision since the last rate Order not to renew the contract is a basis for discontinuing the imputation of directory revenues.

Finally, IBT criticizes GCI/City witness William Dunkel's support for the imputation of directory revenues. IBT argues that the Ameritech Corporation, and not Ameritech Illinois, owns

the “Ameritech” name, and thus Illinois Bell would have no authority to collect “publishing fees”. IBT Brief at 113. This argument is a red herring. Recall that Ameritech Corporation was the entity that wrongfully traded away IBT’s valuable renewal option for the exclusive benefit of the unregulated subsidiary API. No where did Mr. Dunkel assume that Illinois Bell had the ability to “license” use of the Ameritech name. What Illinois Bell did have was the ability to both improve the amount of revenues it would have received under the 1984 contract based on the value of the Ameritech name appearing on the API-published directories, and the ability to ensure that the receipt of revenues extended beyond 1999. It chose not to exercise these options, to the detriment of monopoly ratepayers.

The Company’s argument that Mr. Dunkel could not identify a directory publisher that paid a “publishing fee” to a company for the use of its name is another strawman argument. The issue is whether utility commissions are requiring local monopoly providers of telecommunications service to impute revenues associated with the publishing of directories. Whether or not the incumbent LEC is the entity publishing the directory or characterizes revenues as “publishing fees” is less important than whether revenues associated with directories are being recognized in the Company’s operating income statement for ratemaking purposes.

The Company also argues that neither Mr. Smith nor Mr. Dunkel provided evidence of what the level of “publishing fees” would be. IBT is wrong. As shown in the four-page Schedule E Revised and Schedule E-1 Revised attached to CUB’s Initial Brief (and Mr. Smith’s rebuttal testimony), Mr. Smith provided detailed calculations of why the Commission should impute a minimum of \$126 million in Directory Revenue into AI’s operating income statement for the 1999 test year and for purposes of determining the Company’s revenue requirement on a going-forward basis. GCI/City Ex. 6.2 at 31. As demonstrated in Mr. Smith’s testimony and his

Revised Schedule E-1 and E-1.1, the \$126 million is the minimum amount of directory revenue that should be imputed. Mr. Smith testified, and demonstrated in these exhibits, that the imputed amount could be as much as \$144 million. See GCI/City Ex. 6.2 at 31, GCI/City Ex. 6.5, Schedules E-1 and E-1.1. Accordingly, IBT's arguments in this regard should be rejected.

Finally, the Company launches the ridiculous policy argument that the continued imputation of directory revenues in IBT's revenue requirement would (1) competitively disadvantage all other directory publishers and encourage IBT to sell its endorsement to the highest bidder, (2) continue "subsidies" that "allowed services to be priced below their full costs", and thereby deprive customers of competitive choice, and (3) deprive IBT of necessary funds needed to maintain service quality and upgrade the network "since Ameritech Illinois would not actually receive the imputed revenues." IBT Brief at 116-117. These arguments should be rejected out of hand.

First, it is IBT and its corporate parent who have determined that API shall be the sole publisher of directories that include the Ameritech endorsement on its covers without having to pay IBT additional money for that right. Accordingly, recognizing this valuable asset through the imputation of revenues to the monopoly telephone company corrects this inequity and in no way detrimentally affects competitive publishers of directories. Second, the record evidence supports neither proposition that (1) monopoly services were priced below costs, and (2) that imputing directory revenues somehow prevented other carriers from entering the residential local exchange market. Third, it is difficult to imagine how IBT could assert with any degree of seriousness that imputing directory revenues will deprive the Company of funds needed to maintain service quality. The record evidence has shown that even when the Company earns an astounding 43.08% return on equity, it is unwilling to invest in the local network to a degree

necessary to maintain service quality achieved at pre-price-cap-plan levels. Clearly, there is no correlation between the imputation of directory revenues for ratemaking purposes and IBT's financial ability to maintain service quality.

In sum, IBT's arguments in opposition to Mr. Smith's well-reasoned adjustment for the imputation of directory revenues should be rejected. The Commission should impute a minimum of \$126 million to IBT's test year level of revenues for purposes of computing the Company's revenue requirement.

3. Pension Settlement Gains

In response to both Staff witness Hathhorn's and GCI witness Smith's proposed adjustment to normalize the 1999 test year level of pension settlement gains, IBT first argues that "settlement gains and losses recorded on the Ameritech Illinois' books in 1999 represent the recognition of gains and losses that occurred in prior periods." IBT Brief at 123. The Company adds that because the pension settlement gains recorded in 1999 were abnormally high due to the unusually large number of IBT employees who elected to receive their pensions in a lump sum payment, these amounts should be removed in their entirety from the 1999 operating income statement. Id. at 123-124.

While both GCI and Staff agree that the pension settlement gains recorded in 1999 were at an unusually high level due to the large number of retirements and lump sum dispersals, the Company's assertion that the amounts recorded on the books in 1999 represent the recognition of gains and losses that occurred in prior periods is untrue. As pointed out by Mr. Smith, the amount recorded in the 1999 test year for the pension settlement is a current period credit to expense for 1999, and does not relate back to any prior period items. GCI/City Ex. 6.2 at 25. During cross-examination, Mr. Dominak confirmed that, in fact, these gains were attributable to

people who elected to retire in 1999. Tr. 989-990. Because it is a negative item (i.e., the result of a net gain) in this instance, it is a current period expense *credit*, or reduction to pension cost, in the current period that should be reflected in the test year, but amortized to reflect a normalized level of pension settlement gains. Staff witness Hathhorn testified that Company data showed that pension settlement gains recur on an annual basis. Staff Ex. 6.0 at 7. Both Staff witness Hathhorn and GCI witness Smith concurred that, for ratemaking purposes, the proper treatment of unusually large credits to expense, revenues or expense amounts is to amortize the amount to reflect the normal, recurring amount experienced by the Company on an annual basis – not the wholesale removal of the credit as the Company has done. GCI Ex. 6.2 at 25-26. Mr. Smith’s five-year amortization adjustment, reflected in Schedule E-3 and attached to CUB’s Initial Brief, accomplishes that ratemaking goal.

Similar to the treatment of the Ameritech Illinois pension settlement gains and curtailment losses, the ASI 1999 pension settlement gains should be amortized over a five-year period, rather than being excluded from the test year results entirely, as the Company proposes. The five-year amortization is necessary for the same reasons the pension settlement gain amounts stemming from AI employee retirements should be amortized, and not ignored entirely as AI proposes. GCI/City Ex. 6.2 at 14. The Commission should reflect a five-year amortization of such gains and losses, as shown on GCI/City Exhibit 6.5, Schedule E-15, and attached to CUB’s Initial Brief. This adjustment increases intrastate operating expense before taxes by approximately \$14.829 million.

The Company launches yet another misleading argument by alleging in its Brief that GCI’s proposed adjustment of \$16.938 million for both the IBT-specific and ASI-specific pension settlement gain amortization amounts exceeds the “normal” annual level of pension

settlement gains experienced by IBT on an annual basis by \$9.8 million. IBT Brief at 124. In fact, the Company has taken the dollar value of the GCI adjustment (\$16.9 million), which represents the amount by which the credit to pension expense is decreased, and alleged that that amount inappropriately exceeds the typical annual level of pension settlement gains. This apples-to-oranges comparison is inappropriate and meaningless. The fact remains that Mr. Smith's five-year amortization of the 1999 recorded level of pension settlement gains better reflects the normal, recurring amount experienced by the Company on an annual basis than IBT's wholesale removal of the expense credits.

The Company further opines that the use of a five-year amortization period is arbitrary. IBT Brief at 125. The Company argues that if the gains are to be amortized, an 11.4 amortization period should be used for pension settlement gains related to retiring management employees and a 16-year period for gains related to retiring nonmanagement workers. Tr. at 1005.

IBT's characterization of the GCI/Staff-proposed amortization period and its own amortization proposal should be rejected for all of the reasons stated in CUB's Initial Brief at 123. Second, the amortization periods proposed by IBT relate to the estimated remaining working lifetimes of employees who have *not* yet retired. Consequently, neither period is appropriate for an amortization of pension settlement gains for employees who *have* retired (i.e., are no longer employees and have a zero level remaining working expectation at AI). Mr. Dominak confirmed during cross-examination that neither FAS 87 nor Generally Accepted Accounting Principles require that an amortization be based on a future working lifetime calculation. Tr. at 1008. Because the settlement gains relate to employees who already retired in 1999, their future working lifetime is zero.

Accordingly, IBT's criticisms of Mr. Smith's proposed amortization period should be rejected. A five-year amortization period is reasonable and appropriate under such circumstances, and is consistent with prior Commission treatment of similar cost impacts which are normalized for ratemaking purposes.

Mr. Smith also made an adjustment to amortize over a five-year period the impact of \$98 million in known pension settlement gains recorded by IBT in 2000 for retirements that occurred during the 1999 test year. GCI/City Ex. 6.2 at 22. In its Brief, IBT argues that this adjustment "double-counts" this income statement item "by including adjustments for both the 1999 and 2000 pension settlement gains credits." IBT Brief at 125-126.

The record evidence shows the Company is wrong. During cross-examination, Mr. Dominak confirmed that these amounts, although recorded in 2000, related back to personnel who elected to retire in 1999, but did not receive the lump sum cash payout from the pension plan until 2000. Tr. at 996; AI Ex. 7.2 at 12. Mr. Dominak testified that when the Company recorded the approximately \$98 million of pension settlement gains on its books in the first half of 2000, it did not double count the amount of pension settlement gains that it recorded in 1999. Tr. at 1030. This \$98 million was a separate amount, distinct from the \$98.6 million in pension settlement gains recorded by the Company in 1999. Id. However, the \$98 million in pension settlement gains recorded in 2000 does *relate back to employees who actually retired in 1999 and received their lump sum payments in 1999*. Tr. 1031. The Company simply recorded in 2000 these additional amounts that relate to retirements that occurred during the 1999 test year. Accordingly, it is appropriate to amortize these additional 2000 amounts in order to reflect a normalized level of expense for the 1999 test year.

Moreover, it should be noted that the Company's objection to amortizing gains recorded

in 2000 is inconsistent with the Company's own pro forma proposed adjustments to its 1999 operating income statement for "known and measureable changes" associated with AI tariff changes made in 2000. AI Ex. 7.1, Schedule 1, Tr. at 1030. The five-year amortization period is consistent with Mr. Smith's other recommendations concerning the treatment of the similar 1999 pension settlement gains. This adjustment decreases intrastate expense by \$13.169 million, and is reflected in Mr. Smith's Ex. 6.5, Schedule E-19.¹⁶

For all of the reasons stated above, the Commission should adopt Mr. Smith's proposed pension settlement gain adjustments that are reflected in his Ex. 6.5, Schedules E-3 (AI Pension Settlement Gain), E-15 (Ameritech Services Pension Settlement Gain) and E-19 (AI Pension Settlement Gain – Known 2000 Amounts).

4. Revenues Related to IBT's Failure to Meet Service Quality Standards

As noted in CUB's Initial Brief, the foregone revenue associated with the Company's failure to meet service quality standards is similar to a cost incurred by IBT associated with the failure to meet acceptable service quality standards, and should not be charged to customers. GCI/City Ex. 6.0 at 37. By failing to include the full amount of service quality penalty amounts as revenues, the Company has done just that for ratemaking purposes. Ratepayers should not be forced to pay extra when the Company fails to meet minimum acceptable service quality standards. Consequently, reflecting the level of pro forma revenue as if the Company had fully met service quality standards is necessary so that ratepayers do not subsidize or pay for poor

¹⁶ An alternative calculation shown on Schedule E-19 shows what the impact of this adjustment would be if the Commission adopts the Company's recommendation to revise the nonregulated factor applied to Corporate Operations expense from 13 percent to 4.63 percent. GCI/City Ex. 6.2 at 22.

quality service. Id. This adjustment, reflected in Schedule E-8 and attached to CUB's Initial Brief, restores \$29.579 million of foregone revenue to the test year for the cumulative impact on the 1999 test year for IBT's failure to provide adequate service.¹⁷

The Company objects to this adjustment, arguing that it imputes revenues that IBT did not in fact receive during 1999. IBT Brief at 121. The Company further opines that customers have already received the benefit of cumulative reductions, and that if Mr. Smith's proposed adjustment is adopted, customers would receive the same rate reductions again, and an annual penalty of \$29.579 million would be indefinitely locked into IBT's rates without regard to service quality. Id.

These arguments are red herrings and should be rejected. While it is correct that Mr. Smith's recommended adjustment imputes revenues to the 1999 test year that IBT did not receive because of its failure to meet Illinois service quality standards, such imputation is necessary in order that the 1999 test year revenues reflect, for ratemaking purposes, an appropriate level of revenues as if the Company had provided an adequate level of service to customers. GCI/City Ex. 6.2 at 44. By excluding these foregone revenues from the 1999 test year, the Company seeks to ensure that any going-forward revenue requirement established by the Commission would recoup these lost revenues. The foregone revenue associated with the Company's failure to meet service quality standards is a penalty that should not be charged to customers. The 1999 test year revenues that IBT has lost or foregone because of its failure to meet minimum service quality standards in the state must be added back, or imputed to IBT, in the determination of the 1999 test year revenue requirement, so they can be counted by the

¹⁷ Pro forma Uncollectibles for the test year increase \$494,000.

Commission in resetting IBT's intrastate rates in this proceeding. Id.

Failure to impute these foregone revenues lowers the Company's reported level of revenues, and causes the Company to report a lower earned return. The way to remove the impact of this penalty upon IBT's 1999 test year results is to restore, or impute, the revenues to the test year as if IBT had been providing at least a minimally acceptable level of service quality, and correspondingly did not incur the service quality penalties. This is what Mr. Smith's recommended adjustment accomplishes. Id. at 45.

The Company further opines that if Mr. Smith's proposed adjustment is adopted by the Commission, it should be recalculated to impute only the annual amounts of revenue reductions required in the years 1996, 1997, 1998 and one-half of the 1999 year, for a total of \$11.9 million. IBT Brief at 121. The Company asserts that reflecting the cumulative amount of reductions, as Mr. Smith does, overstates the amount of revenue lost during 1999.

The Company's proposal is misguided, and contradicts its assertion that the Commission should look at the cumulative effect of annual rate reductions when calculating how much rates have been reduced under price cap regulation. Ratepayers must not be penalized for ratemaking purposes for the Company's failure to achieve service quality benchmarks. Setting rates by imputing less than the total amount of revenues foregone lowers the Company's earned return, and accordingly increases its revenue requirement. Rates based on such an inflated revenue requirement would effectively reimburse the Company for the service quality penalty revenues foregone.

The Commission should adopt Mr. Smith's well-reasoned adjustment, shown on Schedule E-8 Revised, which increases revenue by \$29.5 million, and increases Uncollectibles expense by \$494,000. Id.

5. Non-Product Corporate Image-Building Advertising

The Company objects to Mr. Smith's proposed elimination from the 1999 test year of the \$6.807 million of non-product, corporate-image advertising expenses. IBT Brief at 120. While admitting that these ads do not promote a specific product (and therefore help increase revenue), the Company argues that they are intended to "create positive images in the mind of consumers, thereby promoting sales of all of the Company's products and services. Id.

The Company's assertions in this regard should be rejected. Unlike product advertising, which is intended to sell specific products in order to increase regulated revenue, the link between non-product advertising and increased sales of regulated services in Illinois is remote and not quantifiable. Its purpose is to promote the image of Ameritech, now SBC. GCI/City Ex. 6.0 at 35. Therefore, it is appropriate to remove from the test year revenue requirement any non-product/image advertising expenses. Precedent exists for disallowing this type of advertising. In the Price Cap Order of Docket Nos. 92-0488/93-0239, the Commission disallowed such expense. Price Cap Order at 106-107. The same treatment applies in this docket.

6. Asset Disposition Accruals

The Company's 1999 Operating Income Statement included an adjustment to remove in its entirety a \$5.518 million credit to expense associated with "asset disposition accruals." AI Ex. 7.0, Schedule 1. Mr. Smith noted that if the \$5.518 million is to reverse expense over-accruals that built up over a period of several prior years, then a more appropriate ratemaking treatment would be to amortize the credit over a similar period, rather than remove it in its entirety as the Company's adjustment does. GCI/City Ex. 6.0 at 33. For the amortization period, Mr. Smith again used a five-year period, which is the approximate period associated with the build-up of this item. The adjustment reduces

Ameritech Illinois' proposed intrastate operating expense by \$.741 million, as shown in the table on page 34 of GCI/City Ex.6.0 and on Schedule E-5.

IBT argues in its Brief that it was justified in removing this entire expense credit because the transaction that gave rise to the accruals "had nothing to do with 1999 operations." IBT Brief at 126. The Company avers that Mr. Smith's five-year amortization of this amount "improperly reflects prior period activities in the test year. Id. IBT's criticisms miss the mark. First, as explained by Mr. Smith, the basis for reflecting this credit in 1999 results is that the Company actually received the expense credit and recorded it in its 1999 results. GCI/City Ex. 6.0 at 34. IBT witness Dominak confirmed during cross-examination that the Company actually recorded the \$5.5 million credit in 1999. Tr. 977. Moreover, CUB Dominak Cross Exhibit 9 confirms that IBT continued to make property sales during 1999 and 2000. Tr. 977-978. This fact supports including a representative amount of asset disposition accruals in the test year, rather than a wholesale removal of the amount as IBT proposes.

In sum, Mr. Smith's reasonable adjustment to amortize the credit for asset disposition accruals over the same time period the accruals occurred, rather than pluck the entire amount of the credit from the test year, as the Company has done, reflects a normalized level of the impact of this credit, and should be adopted.

7. Interest Synchronization

Both Staff witness Bill Voss and GCI witness Smith proposed interest synchronization adjustments that synchronize the rate base and cost of capital with the tax calculation. GCI/City Ex. 6.0 at 41; Staff Ex. 5.0 at 12. As noted in CUB's Initial Brief, it is calculated by applying the weighted cost of debt to the recommended rate base to obtain a synchronized interest deduction for use in the calculation of test year income tax expense. CUB Initial Brief at 137.

The Company opposes an interest synchronization adjustment, arguing in its Brief that the adjustment does not allow for fluctuation in interest rates with the result of reflecting interest payments "the Company never made in 1999." IBT Brief at 127. The Commission should reject this criticism. Commission precedent for adopting an interest synchronization adjustment is long-standing. The interest synchronization adjustment has been consistently used by the Commission in determining revenue requirements for the utilities it regulates. See Alt. Reg. Order at 103-104.

GCI/City Ex. 6.5, Schedule E-11 Revised, attached to CUB's Initial Brief, shows the calculation of the interest synchronization adjustment based on the product of Mr. Smith's recommended intrastate rate base and the weighted cost of debt Mr. Smith shows for IBT on Schedule D.

8. Revised Non-Regulated Factor for IBT's "Out-of-Period" Adjustment

As noted in CUB's Initial Brief, IBT witness Dominak proposed a revision to the non-regulated factor applied to the Company's proposed \$117.902 million of so-called "prior period" expense, which resulted in a decrease in the 1999 intrastate balance available for return. AI Ex. 7.1 at 4. The Commission should reject this adjustment, as recommended by Mr. Smith, for the reasons stated at page 133 of CUB's Initial Brief.

B. Rate Base Adjustments

1. Telephone Plant Under Construction

This category ratemaking category involves two issues: (1) was a normal level of Telephone Plant Under Construction (TPUC) included in the Company's test year rate base, and (2) how should the Interest During Construction ("IDC") associated with the TPUC be treated so

that it is not double-counted? IBT reflected of \$79.525 million on a total Company basis and \$59.034 million on an intrastate basis on AI Exhibit 7.0, Schedule 2. The Company's rate base amount is based on its December 31, 1999 balance.

Both Mr. Smith and Staff witness Hathhorn proposed an adjustment to reduce the intrastate TPUC amount because the amount IBT included in the test year exceeded the 12-month average TPUC balance significantly for all periods from November 30, 1996 through August 31, 2000, and is thus unrepresentative of normal conditions. GCI/City Ex. 6.0 at 49. Mr. Smith's adjustment reduces the TPUC amount by \$13.130 million to reflect a normal level in this account based on a 36-month average, as shown in GCI/City Ex. 6.5, Schedule E-13. Staff witness Hathhorn first normalized the TPUC amount using a 13-month average, but on rebuttal adopted Mr. Smith's 36-month methodology. Staff Ex. 6.0 at 5; Staff Ex. 20.0 at 5.

In its Brief, IBT offers no argument against adopting Mr. Smith's well-supported adjustment. IBT Brief at 132. It merely notes that in surrebuttal testimony, it added \$26.8 million to Total Plant In Service ("TPIS") associated with a "plug-in circuit board equipment" accrual it alleges is now in service. Id.

The Company's attempt to add this amount to rate base as TPIS should be rejected because the record evidence shows the Company has not yet paid for the plant. As Mr. Dominak admitted during cross-examination, this \$26.8 million amount actually was credited to an account payable or accrued liability, and has not yet been funded by shareholders. Tr. at 986-987. As of December 31, 1999, IBT was still using vendor financing (interest-free capital) to pay for this plant, as evidenced by the balance of \$26.8 million listed in accounts payable. Tr. 988-989, 1177-1178. This fact is also revealed in AI Ex. 7.2, Schedule 4.

The Commission should adopt Mr. Smith's adjustment TPUC adjustment to rate base,

which normalizes the test year level of TPUC, as detailed in GCI/City Ex. 6.5, Schedule E-13, E-13.1, and E-13.3. Adoption of this adjustment effectively deletes Mr. Dominak's proposed addition of the \$26.8 million plug-in circuit board equipment to TPIS. There is a need for consistency between the TPUC amount in rate base and the Interest During Construction ("IDC") amount in the income statement, as explained in GCI/City Ex. 6.0 at 44-47. Although Mr. Smith's IDC adjustment, is preferred, GCI accepts Staff's representation in its Brief that the Commission has yet to adopt the updated rules. Staff's proposed treatment of the IDC amount is a reasonable method of achieving the desired consistency.

2. Accumulated Deferred Income Taxes

IBT subtracted \$97.616 million for "Merger Issues" from the 1999 ADIT balance used as a rate base offset. Responses to discovery and discussions with Company representatives revealed that the two major components of this item are (1) approximately \$60 million relating to a "competitive declaration" and (2) approximately \$21 million for a methodology change in the way AI estimated Uncollectibles. GCI/City Ex. 6.2 at 51.

Although the Company accepted the \$18.685 million Uncollectibles expense adjustment proposed by GCI and Staff, IBT representatives indicated that approximately \$19 to \$20 million of this ADIT debit balance had been included in the \$281.084 million intrastate ADIT balance shown on Company Exhibit 7.0, Schedule 2, Column E. GCI/City Ex. 6.2 at 19. Just as the impact of the Uncollectibles methodology change should be removed from the test year, the related ADIT debit balance item of approximately \$19 to \$20 million for Uncollectibles should also be removed from rate base, as shown on Schedule E-17, attached to CUB's Initial Brief. GCI/City Ex. 6.2 at 19

The Company argues that the \$19 million ADIT adjustment proposed by Mr. Smith is

incorrect because “only the tax effect of the \$18.675 million adjustment to uncollectible expense would impact the rate base.” IBT Brief at 133. The Company argues the correct adjustment to ADIT is \$7.412 million. Id.

The Company again muddles the record. Mr. Smith performed a detailed analysis of the ADIT balances IBT included in the 1999 rate base through discovery and discussions with IBT personnel GCI/City Ex. 6.2 at 18-19. As shown on GCI/City Ex. 6.5, Schedule E-17, line 4, despite the fact that IBT removed the \$21 million associated with Uncollectibles expense in accordance with its adoption of this Staff-/GCI-proposed adjustment, about \$19 million in the ADIT balance associated with the Uncollectibles expense remains in the rate base for the test year, and needs to be removed, notwithstanding IBT’s assertions to the contrary. The adjustment indicated on Schedule E-17, attached to CUB’s Initial Brief should be adopted.

VI. COST OF SERVICE

A. IBT’s Arguments Regarding its New Cost Study Should Be Rejected

IBT’s various arguments that its “new and improved” LFAM cost studies support substantially higher costs for the residential network access line are simply not persuasive. AI Br. at 149-166. Staff and GCI agree that IBT’s flawed cost studies should be given no weight by the Commission. City Br. at 58; Staff Br. at 122-123. Indeed, the Staff concludes that the Commission should use the LRSICs calculated by IBT in the 2000 Aggregate Revenue Test rather than the novel cost studies produced for this proceeding. Staff Br. at 123.

Contrary to IBT’s contention, GCI and Staff challenge the use of the LFAM model, as well as the calculation of the model’s inputs. See AI Br. at 159. As explained in the City’s Initial Brief, the LFAM model is deficient because its design failed to calculate the LRSIC of

the network access line (NAL) based on "least cost currently available" technology, as required by the Commission's cost of service rules. As a result, the LFAM costs reflect more costly older technology and equipment that are not representative of what IBT actually uses. City Br. at 58-61.

IBT's frustration with the Commission's cost of service rules is apparent. IBT argues that "spare capacity costs," properly considered common costs under the Commission's cost of service rules, should be included in LRSIC costs. AI Br. at 138. IBT claims that calculating the NAL LRSIC under the Commission's current rules "understates the incremental costs of network access lines." Id. IBT's position is incorrect.

IBT's proposed treatment of common costs would allocate an unlawfully small portion of common costs to competitive services that share NAL facilities. For example, the Company's proposed assignment of spare capacity costs to the NAL LRSIC would transfer the cost of market development to noncompetitive services until new competitive services need the capacity. While IBT certainly has the right to seek changes to the Commission's cost of service rules, GCI maintain that this proceeding is not the proper forum to test new approaches to the calculation of the company's costs. Certainly, these new approaches cannot support otherwise unjustified increases in the residential NAL.

Although IBT's arguments are totally without merit, as explained in our initial briefs, GCI have identified certain areas where additional comment is necessary.

1. Network Interface Device (NID)

IBT misleads the Commission to conclude that its NID related cost calculations are sound and above criticism by omitting any discussion of IBT's adjustment to its NID related costs as a result of GCI and City witness Dunkel's investigation. AI Br. at 160. IBT witness Palmer

acknowledged that Dunkel's analysis of the NID costs led him to admit to the wrongful inclusion of \$0.04 per access line. AI Ex. 10.1, p. 19. IBT's misidentification of NID related costs (readily admitted in a voluminous record but not mentioned in its brief) reveals a double recovery of NID related costs. Because of this and other errors in IBT's study, IBT's claimed NAL LRSICs should be reduced by \$0.37 per access line, not just by \$0.04.

2. Common Switching Costs

In calculating the switch costs that should be included as an input into the NAL LRSIC, only port-related costs should be included. City Br. at 62. IBT failed to demonstrate that it did not include common switch costs, in addition to port costs, in its calculations. Id. Although IBT denies that it assigned all common costs to the NAL LRSIC, it does not offer any supporting evidence for this assertion. IBT merely asserts that "Mr. Dunkel's suggestion that 100% of the common costs were assigned to NAL service is, therefore, incorrect." AI Br. at 161.

Significantly, IBT does not deny that some common costs were included. Although GCI showed that IBT included 100% of the switch's common costs as an input to its NAL LRSIC, GCI/City Ex. 9.0 at 68, the more important fact is that no amount of common costs should be included.

IBT essentially admits that it improperly included at least some of the common costs in the NAL LRSIC. In describing its methodology, IBT states, "any costs associated with common equipment that are inherent in the single per-line prices of the vendors are, by default, assigned to lines and usage in proportion to their respective implicit costs." (Emphasis added). AI Br. at 161. Because IBT's calculation of switch costs includes common costs, IBT's calculation of NAL LRSICs is improper and the proposed adjustment of the GCI/City expert Mr. Dunkel should be adopted.

3. Line Card Costs

IBT attempts to justify the inclusion of costs for two line cards in its LRSIC study. AI Br. at 161. IBT's justification is not persuasive. Moreover, Ameritech does not even try to justify the inclusion of yet a third line card (part of the COT) that was identified in City (Palmer) Cross Exhibit 17. (That exhibit was included as Exhibit B of the Appendix attached to the City's brief). On cross examination, Ameritech witness Palmer admitted that his cost study improperly included this third line card. Id. See City Brief at 58-61. IBT's improper inclusion of this extra equipment is entirely unjustified and further demonstrates that the LFAM and its cost study are unreliable and cannot be used to justify the substantial NAL rates increases IBT seeks in this docket.

4. Capital Costs

As an initial matter, the Commission should note IBT's selective reliance on the TELRIC proceeding in its brief. On the subject of capital costs, GCI/City witness Dunkel referred to the fact that, in the TELRIC proceeding, the Commission rejected virtually the identical capital structure that IBT is proposing be adopted in this docket. IBT objects, asserting that the decisions in the TELRIC proceeding "do not control" retail LRSIC studies. AI Br. at 164. However, when it fits its purposes, IBT does not hesitate to make a self-serving about-face and cite the TELRIC proceeding as authority. See AI Br. at 139. For example, with respect to the recovery of common costs, IBT asks the Commission to ignore IBT's denigration of the Commission's TELRIC findings and reliance on the TELRIC studies. IBT contends that the TELRIC studies are used to set actual prices, whereas LRSICs are developed for the purpose of setting price floors for retail services. AI Br. at 164. This alleged distinction has no real-world substance, given that IBT is using its LRSIC studies in this case to support actual and substantial increases in the NAL rate, not some theoretical price floor.

With respect to the cost of equity, IBT again attempts to mislead the Commission. IBT states that GCI presented no evidence to support the use of a cost of equity for IBT as low as 11.80% in Mr. Dunkel's cost of service analysis. AI Br. at 165. However, Dunkel's recommendation is fully supported by, and consistent with, the Staff's cost of equity analysis. Mr. Dunkel proposed to use a cost of equity for IBT at the low end of the Staff recommended equity range. GCI/City Ex. 8.0 at 56. His recommendation has gained further support from recent interest rate reductions by the Federal Reserve. GCI and the City respectfully request the Commission take administrative notice of the Federal Reserve's actions pursuant to 83 Ill Adm. Code 200.640.

Staff's recommendation was based on data as of September 6, 2000. Staff Ex. 25.0, at 5. The Federal Reserve reduced interest rates by 0.5% on January 3, 2001, January 31, 2001 and March 20, 2001. Those actions have yielded a total reduction of 1.5% after Staff's analysis was completed. Accordingly, the Staff's recommended return on equity of 13.1%, which is the midpoint of its 11.80 - 14.4% range, does not reflect the impact of these interest rate reductions and should be rejected in favor of Mr. Dunkel's more appropriate recommendation.

5. Shared and Common Costs

IBT acknowledges that Staff, GCI and the City all agree that the NAL rate must cover NAL LRSIC costs. AI Br. at 139. However, IBT contends that the NAL should also cover IBT's unreasonable allocation of shared and common costs as well. In an attempt to justify its position, IBT relies on selected aspects of various other Commission proceedings, including the Commission's universal service docket.

IBT's attempt to use the universal service docket to support its allocation of common costs to the NAL for the purpose of setting the NAL rate is not consistent with the Commission's

use of that methodology in the universal services proceeding. AI Br. at 139. It also conveniently ignores Commission policy defined in that proceeding that supports a basic element of the pricing principles advocated by GCI and the City in this docket.

IBT notes that the costs it calculated in accordance with the FCC's requirement to develop forward-looking economic costs ("FLECs") for universal service purposes include an allocation of common overhead. AI Br. at 139. However, the Commission approved IBT's FLEC methodology in ICC Docket 97-0515 for purposes of determining eligibility for federal high cost funds, not for setting rates. Id.

Also, IBT fails to point out that the Commission's approval of an allocation of common costs was part and parcel of its policy decision declaring that some local usage, in addition to the NAL, should be included in the basic residential service eligible for universal service support. Thus, the Commission's policy determination on basic residential service recognized the close relationship of the NAL and local usage. The Commission found that it was proper to consider revenue from both the NAL and usage services when determining whether universal support is needed.

This recognition by the Commission of the connection between the NAL and usage should inform the Commission's determination of whether rate rebalancing is needed and what rate design to adopt. When residential usage services are considered in conjunction with the NAL, it is clear that residential customers are fully paying their share of all of the company's basic service costs, including common costs, even using IBT's own cost study.

B. IBT's Arguments With Regard To Depreciation Are Unpersuasive

As an initial matter, GCI note that Staff has now calculated a depreciation and amortization amount, including the FAS 71 adjustment, of \$450.8 million for 1999 test year

purposes. See Staff Br., Appendix A, p. 1, column (d). This is an approximately \$48 million change from the depreciation and amortization expense of \$498.2 million attributed to Staff in the City's Initial Brief. See City Br. at 49. This change appears to reflect Staff's inclusion of GCI/City witness Dunkel's recommended adjustments for IBT's improper amortization of Circuit Equipment and "other freedoms." See Staff Br. at 99. This updated Staff amount compares even more favorably with GCI/City's recommendation of \$382.4 million as the appropriate depreciation expense for 1999 test year purposes. See City Br. at 49.

IBT argues that the Commission would somehow deprive the company of the depreciation freedom granted to it in the 1994 Order if GCI/City's recommended depreciation expense were accepted as part of its decision to reduce rates. AI Br. at 97-98. This is nonsense. IBT's argument rests on the false (and unlawful) premise that the Commission irrevocably forfeited its authority and obligation to adjust IBT's rates when it approved the alternative regulation plan, even it finds the rates are unjust and unreasonable. The Commission has a statutory duty to determine and set rates that meet legal requirements if the Commission finds that the earnings produced under the Plan are excessive. An earnings analysis that was clearly contemplated by the Commission in the 1994 Order (See City Br. at 38-40) would logically and carefully consider adjustments to depreciation expenses for the test year in determining proper rate levels.

In any event, IBT's ability to set its depreciation rates during the pendency of the Plan has not been challenged. See City Br. at 47-48. As explained in the City's Initial Brief, IBT's booked depreciation expenses during the Plan, and its reported profits, are not disturbed if the Commission sets just and reasonable rates for the future based on, among other things, GCI/City's recommended depreciation expenses. See City Br. at 55-57. While the company bore the

risk of the depreciation freedom granted to it, it also realized the benefits through substantial increases in earnings that, after covering all expenses, still provided an earned return twice the level authorized by the Commission in the 1994 Order. Id. Neither the benefits nor the risks of IBT's depreciation decisions under the plan are disturbed by reestablishing rates at a just and reasonable level as the Act requires. See, e.g. 220 ILCS 5/9-250 and 5/9-201.

Finally, IBT argues that if the Commission reduces IBT's depreciation expense for rate making purposes (based on the FAS 71 adjustment), as recommended by GCI, the City and Staff, the Commission must increase its rate base by a corresponding amount. AI Br. at 95-96. As explained fully in the City's Initial Brief, this argument is without merit. The effect would be to allow IBT to double recover depreciation expenses. City Br. at 55-57. As IBT candidly acknowledges, Staff agrees with GCI and the City. AI Br. at 128.

C. IBT's Rate Design Proposal Must Also Fail

IBT has not recommended any rate changes other than those in its rate rebalancing petition. AI Br. at 145. Consequently, if the Commission finds that IBT's rates are not just and reasonable, the only alternative rate design proposals in the record are those of Staff, GCI/City.

For the reasons explained fully in the City's Initial Brief, IBT's rate rebalancing proposal should be denied. City Br. at 70-74. The Staff of the Commission agrees that IBT's rate rebalancing proposal has "numerous defects" -- among them reliance on a severely flawed cost of service study -- and should be denied. Staff Br. at 122-124. GCI/City will not repeat their arguments here. GCI/City note, however, that in the current circumstances -- a record that demonstrated that current NAL rates cover LRSIC, company profits in excess of 43% (ROE), and a continuing failure to correct gross service quality failures -- it would be unconscionable, unlawful and poor regulatory policy to increase IBT's non-competitive network access line rate,

which is its most essential and inelastic service.

GCI/ City's alternative proposed rate changes are reasonable and are set at levels designed to cover at a minimum LRSIC costs. In its brief, IBT claims that GCI/City ignored LRSIC costs in the case of proposed reductions to the one-time NAL service and installation charges (non-recurring), reductions which were initially proposed as part of IBT's rate rebalancing petition. IBT Br. at 140. That is not true. GCI and City witness Dunkel did consider LRSIC in this recommendation and found that "[a]ll non-recurring costs are covered by the proposed rates." See GCI/City Ex. 8.0 at 15. Mr. Dunkel considered the revenue stream from both the non-recurring and recurring charges for network access when examining whether rates would cover costs, a view that the Company endorses. See AI Br. at 142. In its rate rebalancing petition, IBT claims that this can be done only if the NAL recurring rate is increased. GCI and the City's analysis proves otherwise. See City Br. at 56-70.

IBT alleges that Band A rates should not be reduced because the costs of these calls are increasing due to increased holding times, and that some day rates may not exceed LRSIC cost. AI Br. at 144. Speculative and unconfirmed estimates of potential costs should not form the basis for Commission rate design policy, particularly when cost of service studies have been presented and thoroughly analyzed by the parties. GCI/ City witness Dunkel's proposed reductions to Band A rates, as well as all other usage service reductions, yield rates that substantially cover LRSIC costs, as calculated by the company. GCI/ City Ex. 8.0 at 22.

GCI/City propose a \$1.30 reduction in the residential and business network access line rate. See City Br. at 76. Although Staff does not make a specific proposal regarding access line rates, GCI/City assume that Staff would not object to this rate reduction because it would satisfy Staff's cost coverage criteria, i.e., that the proposed rates cover LRSIC. Id. IBT, of course,

objects to any rate reduction to the reliable, but excessive, revenue stream produced by the residential NAL. AI Br. at 148. IBT's position rests entirely on IBT's flawed cost study that purports to show that NAL rates do not exceed costs, and therefore, should be given no weight by the Commission.

Finally, GCI/ City support rate reductions for competitive services. Although for different reasons, both Staff and IBT claim that no rate reductions should be made with respect to competitive services. Staff argues that no reductions should be made because the company can simply raise rates later for these services. AI Br. at 145; Staff Ex. 14 at 20. GCI/City disagree that a hypothetical future rate increase action can, or should, prevent the Commission from reducing rates, as mandated by the PUA, based on its finding that those rates are not just and reasonable. As explained in the City's Initial Brief, reclassification of a noncompetitive service to the competitive category does not excuse IBT from providing that service at just and reasonable rates. City Br. at 33-35. If the Commission finds that those rates are not just and reasonable, the Commission must set new rates. If IBT simply ignores this finding and returns those services to the previous rate levels, it is doing so at its own risk.

IBT erroneously argues that competitive services are beyond the scope of alternative regulation. AI Br. at 145. Again, nothing in Section 13-506.1 of the PUA limits this Commission's review only to IBT's noncompetitive rates and Section 13-506.1(b)(4) specifically requires the Commission to consider the rate provisions of Section 13-103(a) of the PUA, which applies to all rates produced under all forms of regulation. City Br. at 34.

For the reasons set forth above and in the GCI Initial Briefs, IBT's rate design proposals should be adopted.

CONCLUSION

For the foregoing reasons, the People of the State of Illinois, the Cook County State's Attorney's Office, the City of Chicago and the Citizens Utility Board request that the Commission adopt the findings and conclusions recommended above and in their Initial Briefs. included in the briefs of the individual GCI parties.

Respectfully submitted:

THE CITY OF CHICAGO

THE PEOPLE OF THE STATE OF
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March 22, 2001

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois Bell Telephone Company)	
)	
Application for Review of Alternative)	Docket No. 98-0252
Regulation Plan)	
Petition to Rebalance Illinois Bell)	
Telephone Company's Carrier Access and)	Docket No. 98-0335
Network Access Line Rates)	
Citizens Utility Board and People of the)	
State of Illinois, ex rel. James E. Ryan,)	
Attorney General of the State of Illinois,)	
Complainants)	
vs.)	Docket No. 00-0764
)	
Illinois Bell Telephone Company d/b/a)	
Ameritech Illinois,)	(consolidated)
Respondent)	

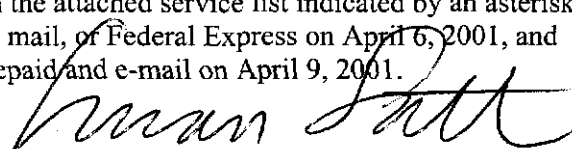
NOTICE OF FILING

PLEASE TAKE NOTICE that on this date, April 6, 2001, we have filed with the Chief Clerk of the Illinois Commerce Commission the enclosed Reply Brief Of The People Of The State Of Illinois in the above-captioned docket by delivering it to United Parcel Service for next day delivery for Donna Caton, Chief Clerk of the Illinois Commerce Commission, at 527 East Capitol Avenue, Springfield, Illinois 62794.


Susan L. Satter
Assistant Attorney General

CERTIFICATE OF SERVICE

I, Susan L. Satter, an Assistant Attorney General, hereby certify that I served the above identified documents upon all active parties of record on the attached service list indicated by an asterisk by personal delivery or United States Mail, or electronic mail, or Federal Express on April 6, 2001, and all other parties by United States mail first class mail prepaid and e-mail on April 9, 2001.


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